EUROPEAN CENTRAL BANK

EUROSYSTEM

OPINION OF THE EUROPEAN CENTRAL BANK

of 3 August 2012

on the stabilising budgetary policy and the creation of an anti-crisis treasury reserves account at Lietuvos bankas

(CON/2012/63)

Introduction and legal basis

On 20 June 2012, the European Central Bank (ECB) received a request from the Lithuanian Ministry of Finance for an opinion on a draft law on the stabilising budgetary policy (hereinafter the 'draft law') and a draft law amending the Law on State debt (hereinafter the 'draft law on State debt') (together referred to as the 'draft laws').

The ECB's competence to deliver an opinion is based on Articles 127(4) and 282(5) of the Treaty on the Functioning of the European Union and the third indent of Article 2(1) of Council Decision 98/415/EC of 29 June 1998 on the consultation of the European Central Bank by national authorities regarding draft legislative provisions[1], as the draft laws relate to Lietuvos bankas. In accordance with the first sentence of Article 17.5 of the Rules of Procedure of the European Central Bank, the Governing Council has adopted this opinion.

1. Purpose of the draft laws

1.1 The purpose of the draft law is to provide a means of responsible management for sustainable public finances, *inter alia* by creating an anti-crisis treasury reserves account (hereinafter the 'special account') at Lietuvos bankas. The primary purpose is to finance Lithuanian governmental functions in difficult times, including measures to strengthen financial stability, provided by the Law on financial sustainability[2]. According to the draft law, the Lithuanian Government may officially declare difficult times if one of the following circumstances arises:

(a) GDP is decreasing or not increasing sufficiently, in particular:

(i) chain-linked volume of GDP per calendar quarter is decreasing or increasing by less than 1% compared to the respective quarter of the previous year, or, according to Lietuvos bankas' assessments, the chain-linked volume of GDP will decrease or increase by less than 1% during the current or next calendar year;

1 OJ L 189, 3.7.1998, p. 42.

2 *Valstybės žinios*, 2009, No 93-3985.

(ii) nominal GDP per calendar quarter is increasing by less than 3%, or, according to Lietuvos bankas' assessments, the nominal GDP will increase by less than 3% during the current or next calendar year[3];

(b) the Lithuanian Government is not able to borrow at less than 6% of an annual interest rate and decides not to issue government securities[4];

(c) the Lithuanian Government needs to finance measures to strengthen the financial stability of the banking system[5].

If a crisis was not officially declared, the funds could also be used to increase Lietuvos bankas' regulatory capital and reduce general government debt if it becomes higher than 55% of GDP.

1.2 The draft law will enter into force on 1 July 2013 and the provisions covering the use of funds in the special account to increase the regulatory capital of Lietuvos bankas will be valid until introduction of the euro in Lithuania.

1.3 The draft law on State debt provides that Lietuvos bankas will sign an agreement with the Lithuanian Government allowing Lietuvos bankas to use and make financial investments with the funds in the special account. The draft law on State debt is intended to enter into force on 1 July 2013 and apply from 1 January 2014.

2. General observations

The ECB welcomes the draft law, which creates a fiscal reserve for difficult times. The ECB understands that the draft laws are part of the legislative package transposing Council Directive 2011/85/EU of 8 November 2011 on requirements for budgetary frameworks of the Member States[6] and are intended to fully comply with the Stability and Growth Pact and the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union. In this regard, the ECB suggests removing any provisions possibly in conflict with the Union fiscal governance framework, i.e. Article 5 of the draft law that contains details about long-term budgetary policy stimulating aggregate demand, 3% consumer price index inflation and the current account deficit exceeding 8% of GDP.

3. Definition of difficult times

3.1 The ECB recommends that the criteria for the Government to declare difficult times are narrowed, e.g. to a negative real GDP growth instead of GDP growth up to 1%; however, other criteria (including a natural disaster, a severe economic downturn[7] or a financial crisis etc.) must also be

3 Article 6(1)(1) to 6(1)(4) of the draft law.

4 Article 6(1)(5) of the draft law.

5 Article 6(2) of the draft law.

6 OJ L 306, 23.11.2011, p. 41.

7 As defined in Article 2(2) of Council Regulation (EC) No 1467/97 of 7 July 1997 on speeding up and clarifying the implementation of the excessive deficit procedure (OJ L 209, 2.8.1997, p. 6), referring to a 'negative annual GDP volume growth rate' and an 'accumulated loss of output during a protracted period of very low annual GDP volume growth relative to its potential'.

taken into account when defining the circumstances leading to the declaration of difficult times. Alternatively, the criteria could be broadly defined to allow the authorities some discretion in reacting to unforeseeable events, but when declaring difficult times, there must be joint agreement to do so by several authorities, e.g. the Prime Minister, the Finance Minister, the Chairperson of the Board of Lietuvos bankas and the Chair of the Parliament.

3.2 In addition, as regards the Lithuanian Government's ability to borrow, the ECB recommends replacing a reference to the specific fixed benchmark of an annual interest rate of 6% with a reference to an established variable benchmark.

3.3 In regard to the financial stability of the banking system, the ECB recommends making references to other relevant national legislation[8] to ensure that the appropriate national authorities are consistently involved in making decisions.

4. Definition of general government debt

4.1 The ECB understands that the term 'general government debt' in the draft law has the same meaning as in Article 1(5) of Council Regulation (EC) No 479/2009 of 25 May 2009 on the application of the Protocol on the excessive deficit procedure annexed to the Treaty establishing the European Community[9]. For the purpose of clarity, however, the ECB suggests inserting the definition of general government debt in the list of definitions and clarifying the valuation and consolidation of general government debt and the financial instruments covered[10].

4.2 The ECB also recommends that the level of debt mentioned in Article 3(2)(2) of the draft law should additionally refer to the abovementioned Protocol and to Regulation (EC) No 479/2009.

5. Definition of 'secure and profitable investment return'

5.1 The draft law requires Lietuvos bankas to use funds in the special account for financial investments at a 'secure and profitable investment return per year[11],' which should not be lower than (a) an investment return from the foreign reserves invested by Lietuvos bankas during the same period; or (b) a yearly investment return from the investments in German government securities, whichever is higher. The ECB recommends replacing the reference to return requirements and investment horizon by a reference to the risk profile of investments. A detailed investment mandate specifying the duration, credit quality of financial instruments, other requirements and objectives should be specified in an agreement with Lietuvos bankas[12] as this will have a considerable impact on the

8 E.g. Government Resolution No 1253 of 24 November 2008 on the approval of the financial crisis prevention and management plan (*Valstybės žinios*, 2008, No 140-5549).

9 OJ L 145, 10.6.2009, p. 1.

10 See ECB Opinion CON/2011/96, paragraph 5. All ECB opinions are available on the ECB's website at www.ecb.europa.eu.

11 Article 4(7)(1) of the draft law.

12 As referred to in Article 4(6) of the draft law.

return. If the return is based on a specific investment horizon, the objective should be to immunise the interest rate risk by using a similar duration.

5.2 The profitability depends on price movements during the holding period and can normally only be confirmed *ex post*, after the holding period has expired. Moreover, when a 'secure' instrument is referred to, normally a minimum credit rating of eligible instruments is stated. This will not guarantee whether the instrument or asset class is 'profitable', so the use of this concept is not recommended in this context.

6. Central bank independence and prohibition on monetary financing

6.1 *Central bank independence*

The ECB takes note of the recognition of Lietuvos bankas' expertise in the stability of the financial market by entrusting it with the management of the special account's funds, including its financial investments, and by including Lietuvos bankas in the decision-making process in regard to the declaration of start/end of difficult times. In this respect, the ECB notes that any involvement of Lietuvos bankas in application of the measures provided by the draft law must be compatible with the Treaty. The ECB expects that, when implementing the measures provided by the draft law, Lietuvos bankas' involvement will be fully compatible with its institutional and financial independence[13] to safeguard the proper performance of its tasks under the Treaty and the Statute of the European System of Central Banks and of the European Central Bank. The principle of central bank independence, *inter alia*, requires that Member States do not put their national central banks (NCBs) in a position where they have insufficient financial resources and inadequate net equity to carry out their tasks related to the European System of Central Banks or Eurosystem.

6.2 *Prohibition on monetary financing*

6.2.1 It is important to safeguard compliance with the monetary financing prohibition under Article 123 of the Treaty. This prohibition is designed to prevent NCBs from providing overdraft facilities or any other type of credit facility to the public sector, which includes any financing of the public sector's obligations in relation to third parties. The ECB expects that Lietuvos bankas' involvement in the procedure provided for in the draft law will comply not only with the principle of central bank independence as specified in the paragraphs above but also with the prohibition on monetary financing laid down in Article 123(1) of the Treaty, read in conjunction with Council Regulation (EC) No 3603/93 of 13 December 1993 specifying definitions for the application of the prohibitions referred to in Articles 104 and 104b(1) of the Treaty[14].

6.2.2 In particular, the draft law refers to activities to be carried out by Lietuvos bankas as a fiscal agent of the State. Taking into account the express recognition in Article 21.2 of the Statute of the provision of fiscal agency services as a legitimate function traditionally performed by NCBs, the

13 ECB's Convergence Report, May 2012, p. 21-27.

14 OJ L 332, 31.12.1993, p. 1.

provision by central banks of such services complies with the prohibition on monetary financing, provided that they remain within the field of the fiscal agency function and do not constitute central bank financing of public sector obligations vis-à-vis third parties or central bank crediting of the public sector outside the narrowly defined exceptions specified in Regulation (EC) No 3603/93. National legislation that enables an NCB to hold government deposits and to service government accounts does not raise concerns about compliance with the monetary financing prohibition as long as such provisions do not allow the extension of credit, including overnight overdrafts. Moreover, an NCB providing fiscal agent services without remuneration does not raise monetary financing concerns, provided they are core fiscal agent services[15].

6.2.3 The ECB understands that Lietuvos bankas' fiscal agent services provided for under the draft law will not result in any central bank funds being provided to the State or the State's obligations being financed by Lietuvos bankas, including by means of bridge financing.

6.3 *Maximum return from investments*

6.3.1 Article 4(7)(1) of the draft law provides that Lietuvos bankas may seek lower than maximum returns from investments of the funds in the special account, if the investments are necessary to achieve or maintain price stability or if requiring the maximum annual return would not achieve or maintain price stability. This provision would not be compatible with the principle of functional and institutional independence of an NCB, if the State interferes with the independent decision by Lietuvos bankas on whether and under which conditions investments are necessary for achieving or maintaining price stability. Furthermore, the ECB understands that the draft law does not require a specific return from such investments. The ECB recommends clarifying the wording of the draft law to avoid any doubt. Generally an NCB is expected to exercise financial prudence, but the sole objective of its monetary policy operations is price stability not profit.

6.3.2 In addition, and with reference to the considerations under Section 5 above, the ECB understands that Lietuvos bankas is under an obligation to use all possible means to reach the objectives set out in the draft law in term of returns but that Lietuvos bankas is not required to reach any particular result. Therefore, Lietuvos bankas will not be asked to compensate on its own funds or be 'penalised' for any unattained result in terms of returns. This is of particular relevance due to the precise conditions and deadlines also contained in the draft law for possible repayments of funds held in the special account to the general account of the State.

6.3.3 In this context, as there are no explicit provisions in either draft law regarding the responsibility for losses from (interrupted) financial investments or unattained investment returns, the draft laws should specify that Lietuvos bankas, as fiscal agent for the State, has no responsibility for those losses and the State must cover them.

15 ECB's Convergence Report, May 2012, p. 30.

6.3.4 The ECB understands that, if the special account's funds are entered into Lietuvos bankas' balance sheet, the respective accounting information will be disclosed in the 'notes' part of the annual financial statement of Lietuvos bankas[16], rather than in a separate statement[17].

6.4 *Increase of Lietuvos bankas' statutory capital*

6.4.1 Whereas the draft law remains silent as to whether the funds in the special account, used for increasing Lietuvos bankas' statutory capital, should also remain there if the State urgently needs additional financial resources to deal with a crisis situation, the ECB understands that this statutory capital, once it has been increased by the funds in the special account, cannot be reduced again at short notice nor with a different procedure from the one provided in the draft law for the increase of the capital[18]. The draft law should contain an explicit safeguard pertaining to this situation. A Member State may not impose reductions of capital on an NCB without the *ex ante* agreement of the NCB's decision-making bodies that must ensure that the NCB has sufficient financial means and adequate net equity to fulfil its mandate[19].

6.4.2 The ECB recommends that a reference in Article 10(2) of the draft law to the 'accounting value'[20] of the financial investments, which is to be taken into account when increasing Lietuvos bankas' statutory capital, should be replaced by a reference to the 'market value at the moment of the capital increase' to avoid a situation where the intended capital increase is not adequately funded, e.g. if the accounting value is significantly above the market value.

6.4.3 Finally, the ECB understands that the draft law provisions, while giving a deadline of the date of introduction of the euro in Lithuania to use funds in the special account to increase Lietuvos bankas' statutory capital, do not limit the general possibility – also after euro introduction – to increase Lietuvos bankas' statutory capital from other funds[21].

This opinion will be published on the ECB's website.

Done at Frankfurt am Main, 3 August 2012.

[signed]

The Vice-President of the ECB

Vítor CONSTÂNCIO

16 Article 12 of the draft law.

17 Financial statements of Lietuvos bankas currently comprise the following elements: balance sheet, profit and loss accounts and explanatory notes.

18 See Article 10 of the draft law.

19 ECB's Convergence Report, May 2012, p. 33.

20 Article 10(2) of the draft law.

21 Article 20(2) of the Law on Lietuvos bankas provides that the statutory capital of Lietuvos bankas, currently LTL 200 million comes from State funds and/or Lietuvos bankas' profits.